An Update on the Solvency Issues at Valeant Pharmaceuticals Intl Inc.

Description

Last week, **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) reported earnings that finally surpassed expectations. Earnings per share came in at US$1.74, which is a significant step given that the company lost money for the same period a year ago.

While this is good news for shareholders, it does not mean new investors should run out to purchase shares.

While the stock increased by more than 35% last week, the company is far from out of the woods. Reporting revenues of US$2,109 million for the quarter, the year-over-year decline is close to 11%. Meanwhile, expenses have not followed suit.

One of the most important expenses for any pharmaceutical company is the combination of interest expenses and research and development (R&D) expenses. While the average for most companies is closer to 15%, the situation at Valeant has gotten no better over the past year. During fiscal 2016, the interest expenses alone was 18.9% of revenues, which was an increase from the previous year's amount of approximately 15%.

Things continued to go downhill during the first quarter of 2017 as revenues have decreased by close to 11%, leading the interest expense to account for a whopping 22% of revenues.

While many would argue that any one quarter does not make or break a company, it is important to understand that the interest expense is consistent across all four quarters, and the revenues of most pharmaceutical companies are also very consistent throughout the year. In the case of Valeant, revenues in the first quarter made up 24.8% of total revenues for the year, followed by 25.6% for the second quarter, followed by 25% for the third quarter, and 24.5% for the fourth quarter.

It is clear that there is low variability in revenues and interest expenses over the four fiscal quarters of the year. Instead, investors need to take time and examine the financial health of the company and how it is deteriorating.

The good news for long investors of the stock is the amount of debt was reduced by approximately

US$1.3 billion throughout the quarter. In the hopes of reducing the interest expense, the company has agreed to cash out of specific products (or business units) by selling to competitors. While this will provide a temporary cash inflow to pay down debt, the result is, the company may be worse off.

Once a revenue-generating part of the operation is sold off, the recurring revenues decline permanently. The revenue-generating assets will no longer bring in enough cash to pay off the debt load, which totals close to US$28.5 billion.

While the company has close to US$1.2 billion in cash on the balance sheet, the interest expenses will simply cost too much to service. The lack of amortizing debt, which was taken on over the past five years, is what has led us to this point. The debt load will cripple Valeant. The question investors need to ask themselves is not if, but when it will happen.

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ryangoldsman